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FOREIGN ACTIVITY

An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

Vol. XVII, No. 5 October 16, 1991

Reversal Of Fortune

In the first half of 1991, foreign investors enjoyed a combination of declining U.S. interest rates, a strengthening dollar and a sharp rise in equity prices, with the Dow passing 3000 for the first time in April. Further bouyed by hope for a U.S. economic recovery, foreign investors turned to the U.S. equity market. With net purchases of $7.7 billion in 2Q91 -- the largest quarterly takedown since 2Q87's $8.7 billion -- cumulative first-half acquisitions rose to an impressive $10.4 billion. Considering last year's record $15.1 billion sell-off, the 1H91 equity *inflow* is all the more impressive. In addition, acquisitions of U.S. treasuries, at $14.1 billion, also proved surprising. In total, first-half net purchases of U.S. securities neared $36 billion.

Foreign investors not only reversed last year's pessimistic posture, but showed that despite the worldwide need for capital, the U.S. capital markets can continue to attract foreign funds when U.S. economic indicators appear favorable. However, we do not expect that the U.S. would attract the levels of foreign capital seen in the later part of 1980s; because of this, the U.S. will increasingly rely on a shrinking pool of domestic savings to finance its growth.

1H91 Foreign Flows Into The U.S.:
Better Than Expected
($Bils.)

	1H91	*1H90*	*Net Change*
Equities	10.4	(7.0)	17.4
Treasuries	14.1	(2.5)	16.6
-Private	*19.0*	*(1.3)*	*20.3*
-Public	*(4.9)*	*(1.2)*	*(3.7)*
Agencies	2.2	3.7	(1.5)
Corp. Bonds	9.2	7.9	1.3
Total Portfolio	35.9	2.1	33.8
Total Direct	7.6	25.6	(18.0)
Total All	43.5	27.7	15.8

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The 1H91 foreign inflows contrasts with the 1980s, where institutional investors, particularly those whose foreign asset holdings were artificially constrained by capital controls, built up dollar holdings irrespective of, for instance, the falling dollar. In that most major capital suppliers, particularly the Japanese, built large dollar positions during the 1980s, the need to invest in the U.S. will more often be driven by the economy, and less by dollar allocation. Put slightly differently, the foreign fund manager is increasingly looking at returns on capital and is less interested in the allocation of the total portfolio between dollars and other currencies as in the past.

Foreign Activity In U.S. Equities

GROSS TRANSACTIONS IN AND NET PURCHASES OF
U.S. EQUITIES BY FOREIGN INVESTORS
($Mils.)

	FIRST QUARTER 1991		*SECOND QUARTER 1991*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 2Q91-1Q91*
EUROPE	**$52,847**	**($1,153)**	**$55,508**	**$3,576**	**5.0%**
BELGIUM LUXEMBOURG	3,412	(14)	3,556	200	4.2%
FRANCE	3,669	82	4,124	208	12.4%
GERMANY	3,424	(318)	3,396	86	(0.8%)
NETHERLANDS	2,498	(128)	2,245	119	(10.1%)
SWITZERLAND	9,400	(808)	8,977	1,187	(4.5%)
UNITED KINGDOM	25,999	(99)	29,032	1,124	11.7%
CANADA	**11,822**	**778**	**12,293**	**1,205**	**4.0%**
LATIN AMERICA & CARIBBEAN	**15,098**	**1,174**	**16,008**	**644**	**6.0%**
BERMUDA	2,307	45	2,847	(115)	23.4%
NETHERLANDS ANTILLES	5,410	934	4,670	66	(13.7%)
ASIA	**22,806**	**1,824**	**20,596**	**1,728**	**(9.7%)**
HONG KONG	2,337	397	1,803	65	(22.8%)
JAPAN	13,340	(640)	13,084	1,908	(1.9%)
OIL EXPORTING COUNTRIES	4,245	366	4,116	(435)	(3.0%)
TOTAL ALL COUNTRIES*	**$104,777**	**$2,649**	**$106,550**	**$7,704**	**1.7%**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

European investors' second-quarter commitment to the U.S. was widespread, with all European countries analyzed in the *FAR* showing net purchases. Foreign investors, prodded by an "I'm missing the rally" mentality, used the strengthening dollar as a platform to jump back into the U.S. equity market. In addition, the dramatic political and economic transformations taking place in Eastern Europe are making European investors uncertain as to the potential positive impact of a unified Europe on

economic growth. In this case, investment in the U.S. may seem an attractive alternative.

The long lost Swiss investor also returned in 2Q91. Dating back to the 4Q87, Swiss investors have made net sales of U.S. equities in every quarter, totalling $10.3 billion. As the table below shows, the Swiss were, by far, the largest divestors of U.S. equities since 4Q87. During this period of divestment, the Swiss market has outperformed Europe as a whole, and by the end of the 1H91, had performed as well as the U.S. market. Moreover, from mid-1985 to the beginning of 1990 the Swiss market significantly outperformed the U.S. market. So, to some extent, this trend is not surprising.

Foreign Net Purchases Of U.S. Equities, 2Q91-4Q87

($Mils.)

Japan	5,696
Canada	3,706
Belgium/Luxembourg	(142)
Netherlands	(481)
Germany	(1,195)
OPEC	(1,716)
France	(2,508)
U.K.	(3,675)
Switzerland	**(10,262)**

Ironically, not only did the Swiss actually lead the European march back into U.S. equities -- 2Q91 net purchases totalled near $1.2 billion -- but also acquired a record quarterly level for customers of Swiss intermediaries. Despite the conservative nature of the Swiss investor, the severe paring of their dollar-based equity holdings during the past years may have led to a decision to rebuild. With the dollar showing continued strength, inflation in Switzerland running at a decade high, and economic growth among the weakest in Europe, the timing was opportune to purchase U.S. equities.

Canadian investors made net purchases of $1.2 billion in 2Q91, a record quarterly takedown. Indeed, Canadian investors are well on their way to record acquisitions of U.S. equities in 1991. Given the recent poor performance of Canadian markets and a deepening recession, the U.S. market has become something of a home-away-from-home for Canadian investors. Moreover, the phased in increase for Canadian pension fund holdings of foreign assets, as well as the implementation of the Multi-jurisdictional Disclosure System, which will facilitate cross-border equity offerings between the U.S. and Canada, should lead to greater interest in the U.S. market and vice versa.

The recent cautious attitude of Japanese investors toward U.S equities was reversed in 2Q91; net acquisitions of $1.9 billion surpassed that of any other country. While we don't expect a re-emergence of substantial flows of Japanese capital to the U.S. -- net capital outflows from Japan 1H91 turned inward for the first time since 1980 -- the strong performance of the dollar may still entice Japanese investors.

Foreign Activity In U.S. Treasuries - Dutch Treat

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. TREASURY NOTES AND BONDS BY FOREIGN INVESTORS
($Mils.)

	FIRST QUARTER 1991		*SECOND QUARTER 1991*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 2Q91-1Q91*
EUROPE	**$441,492**	**$1,722**	**$405,677**	**($55)**	**(8.1%)**
GERMANY	29,917	(5,606)	20,084	(574)	(32.9%)
SWITZERLAND	9,442	778	8,182	(186)	(13.3%)
UNITED KINGDOM	287,922	3,288	273,996	708	(4.8%)
ASIA	**435,272**	**3,608**	**411,851**	**(3,051)**	**(5.4%)**
JAPAN	362,311	(2,821)	340,585	(1,245)	(6.0%)
OIL EXPORTING COUNTRIES	23,063	(318)	18,625	(2,027)	(19.2%)
NONMONETARY INT'L & REGIONAL ORG'S	**44,110**	**(1,082)**	**31,784**	**(38)**	**(27.9%)**
TOTAL ALL COUNTRIES*	**$1,020,533**	**$492**	**$956,337**	**$13,609**	**(6.3%)**

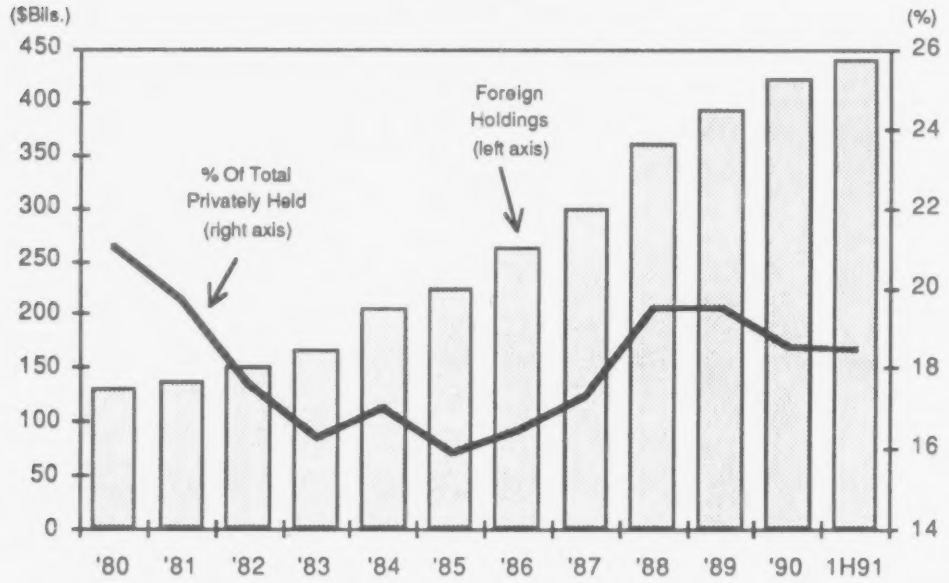
Source: U.S. Treasury
* Activity incorporates revised data

The second-quarter foreign inflow to the U.S. Treasury market was a welcome $13.6 billion dollars; official institutions sold off $1.1 billion, while private investors acquired near $16.3 billion. However, there was less here than meets the eye. Interest among private investors was not widespread: Spain (near $1.7 billion), Mexico (almost $1.3 billion), Canada ($793 million) and the U.K. ($708 million) were the largest players. Otherwise, the two areas of the world on which the U.S. depends for capital -- Asia and Europe -- were, on the whole, net sellers. Oddly, it was money from Latin America and the Caribbean which supplied the punch. Bermuda's second-quarter takedown was near $5.9 billion, while investors from the Netherlands Antilles acquired a whopping $7.8 billion.

Total foreign net purchases in 1H91 came to slightly over $14.1 billion. At an annualized rate, U.S. Treasury purchases by foreign investors will be above last year's $19.7 billion, but well below the peak years of 1988 and 1989, when acquisitions

totalled $48.8 billion and $54.2 billion, respectively. The reduction in interest in U.S. Treasuries is seen by the decline in the rate of growth in foreign holdings, which is depicted in the graph below. Interestingly, the reduced purchases of U.S. Treasuries by foreign investors has been off-set by a sharp increase in Treasury purchases by U.S. banks, perhaps serving to keep interest rates at lower levels.

Foreign Holdings Of U.S. Public Debt



One other interesting point to note is the position taken by official institutions, who've made net divestitures of Treasuries during 1H91 of almost $4.9 billion. This current pace could represent a significant departure from the pattern of the post-floating exchange rate era, during which central banks made net acquisitions of U.S. Treasuries. The last time net sales were made was in 1974, totalling $640 million. Net selling in 1H91 represented a concerted attempt by central banks to blunt the surprise rally in the dollar. Indeed, except for the U.K., the total reserves (minus gold) held by each of the G-7 countries as of mid-year 1991 fell from their year-end 1990 position.

U.S. Acquisitions Of Overseas Securities - U.S. Investors Load Up

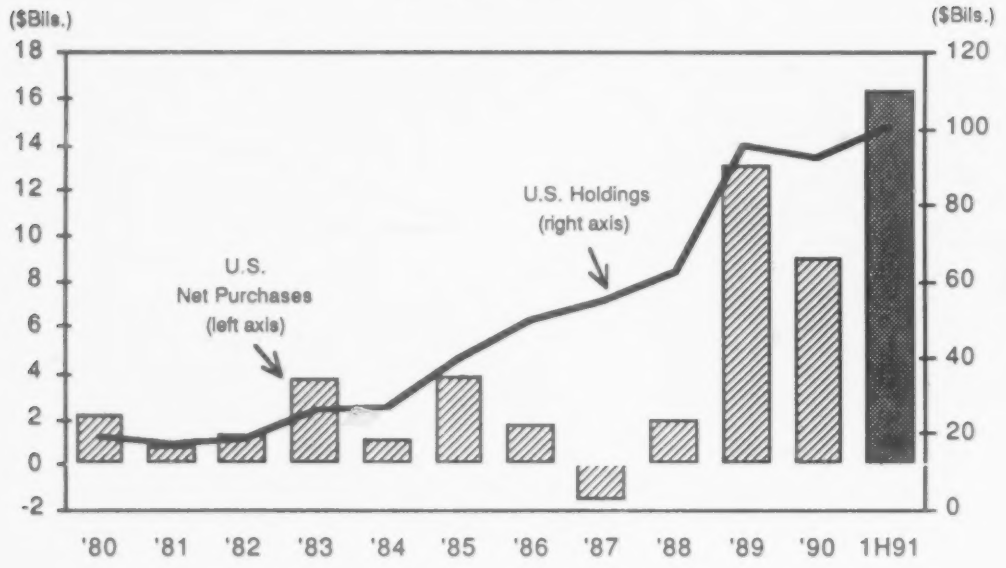
GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($Mils.)

	FIRST QUARTER 1991		*SECOND QUARTER 1991*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 2Q91-1Q91*
EUROPE	**$36,958**	**$2,332**	**$36,729**	**$5,015**	**(0.6%)**
EUROPEAN COMMUNITY	*$33,269*	*$1,761*	*$35,559*	*$4,805*	*6.9%*
BELGIUM/LUXEMBOURG	471	(35)	401	(9)	(14.9%)
DENMARK	132	30	144	24	9.1%
FRANCE	2,618	106	3,015	695	15.2%
GERMANY	3,203	645	2,225	505	(30.5%)
GREECE	8	2	19	15	137.5%
IRELAND	52	(30)	119	41	128.8%
ITALY	1,676	252	658	100	(60.7%)
NETHERLANDS	1,975	(187)	2,094	588	6.0%
PORTUGAL	10	0	9	5	(10.0%)
SPAIN	1,250	128	1,005	139	(19.6%)
UNITED KINGDOM	21,874	850	23,498	2,680	7.4%
SWITZERLAND	2,456	290	2,372	22	(3.4%)
CANADA	**2,709**	**(385)**	**3,412**	**(218)**	**26.0%**
LATIN AMERICA & CARIBBEAN	**2,417**	**(241)**	**4,726**	**1,556**	**95.5%**
MEXICO	532	146	2,603	1,595	389.3%
ASIA	**18,853**	**5,275**	**15,561**	**2,845**	**(17.5%)**
JAPAN	15,996	5,230	11,795	2,613	(26.3%)
OTHER	**1,721**	**(95)**	**1,376**	**394**	**(20.0%)**
TOTAL ALL COUNTRIES*	**$62,658**	**$6,886**	**$62,335**	**$9,437**	**(0.5%)**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

Perhaps the most stunning story in 1991 so far is U.S. investor purchases of foreign equities. No matter which way you slice it, the first half of 1991 has been one for the records. First-half acquisitions stand at $16.3 billion, more than $3 billion above 1989's *full-year record* of $13.1 billion. Moreover, 2Q91 net purchases alone totalled $9.4 billion, easily a quarterly record. Interestingly, 1H91's acquisitions were not accompanied by a surge in volume. This indicates that, at least in the first half, the main concern of the U.S. investor was to accumulate foreign equities, not buy and trade.

U.S. Net Purchases Of Foreign Equities



All the more impressive is that U.S. foreign equity purchases have occurred despite a strong showing in the U.S. equity markets. Given the admirable performance of the U.S. stock market in 1Q91, up 14.1%, and 12.6% for the first half, it is a little hard to understand why U.S. investors acquired unprecedented levels of (as measured by the *FT-Actuaries World Indices*) foreign equities. The explanation may lie on both economic and investment strategy grounds. First, net flows into the Mexican market totalled $1.6 billion, well over last year's total acquisitions of $909 million. This "spike" in net activity is a result of the May 1991 privatization of the Mexican telephone company, Telefonos de Mexico. The U.S. tranche of this deal totalled near $1.2 billion (44 million ADRs priced at $27.25). In addition, U.S. investors continued to look for investment opportunities in the EC, and further increased their holdings of Japanese equities.

The economic backdrop for U.S. activity overseas in 2Q91 was a declining interest rate environment, rising equity prices, and a general impression that a global economic upturn was not too far out on the horizon. The surge in U.S. foreign investment in 1991 was also a function of the heavy beating taken by stock markets in 1990 which left many European countries below their previous highs. For example, Germany and France were down over 20% while Japan plunged over 40%; presumably, this resulted in some bottom fishing by U.S. and other investors. One might make the case that U.S. investors are well positioned for any global equity market rally.

Performance Of Selected Equity Markets, 1H91

	Local Currency	*U.S. $*
Mexico	72.4%	68.8%
Sweden	36.3	17.0
Denmark	23.4	2.1
Spain	23.1	3.5
Switzerland	20.0	(1.7)
Netherlands	18.8	(1.9)
Ireland	16.1	(3.7)
Belgium	14.3	(0.5)
France	14.0	(5.6)
Italy	13.1	(5.4)
Germany	12.8	(7.1)
U.S.	**12.6**	**12.6**
U.K.	12.5	(5.6)
Canada	4.8	6.5
Japan	4.6	2.9

Source: *FT-Actuaries World Indices*

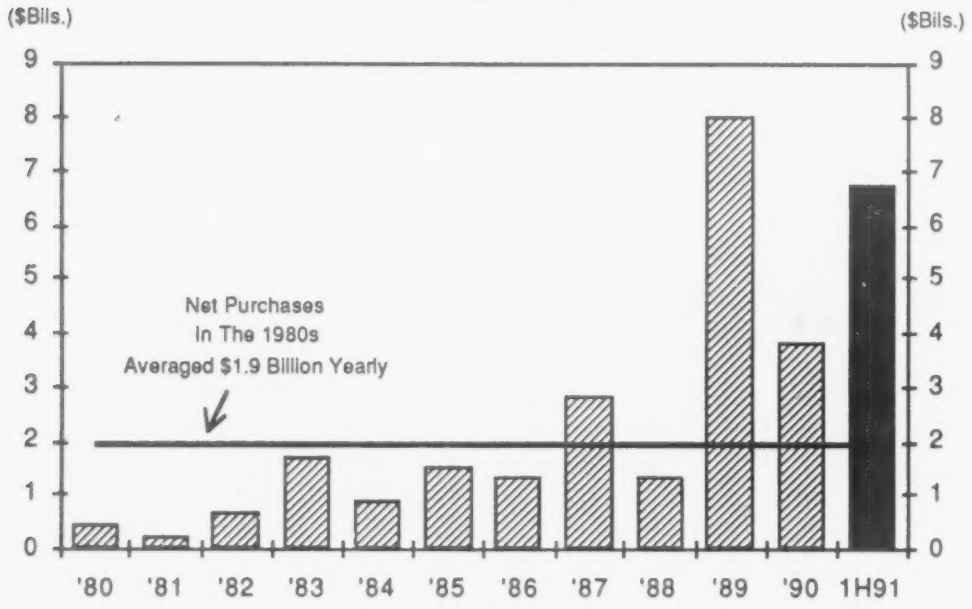
As shown in the table above, during 1H91 equity prices in Europe performed better, in local terms, than U.S. equities. While dollar adjusted returns were disappointing, the long-run investment strategy taken by U.S. investors suggest that not only do U.S. investors expect good future performance, but they are also betting that the sharp rally in the U.S. dollar may have seen its best days. So, expect for Belgium/Luxembourg, U.S. investors made net purchases in all other EC member states. The total for 2Q91 was almost $5 billion; 1H91 stands at over $7.3 billion.

Substantial acquisitions of U.K. equities totalling $2.7 billion were spurred on by several cuts in the U.K. lending rate made in the 1H91, from 14% to 11.5%. Despite news that the U.K. economy was deep in recession and March 1991's unemployment rise was the largest on record, U.S. investors looked to get in on the ground floor of a U.K. economic recovery.

In general, U.S. investment in EC equities has been at minimal levels, averaging net purchases of just under $2 billion per year in the 1980's. Only since 1989 have levels increased enough to be called substantial. On the back of a 24% increase in European equity prices, U.S. acquisitions peaked in 1989 at over $8 billion. While equity prices in 1990 twisted and turned, finally posting a 18.7% (local currency) decline, U.S. investors still acquired near $3.8 billion of European equities. Net acquisitions in 1991 indicate the increasing commitment U.S. investors are making towards EC, and to diversifying their portfolios. A recent survey by *Broadgate*

Consultants, Inc. noted that American fund managers consider continental Europe as the most attractive investment market, with 70% responding that prospects were excellent or good.

U.S. Net Purchases Of EC Equities



While half the first quarter's eye popping $5.2 billion, U.S. investment in Japan in 2Q91 was still a significant $2.6 billion. U.S. investment in Japanese equities for the 1H91 is nearly $8.0 billion, or nearly half of all U.S. *foreign* net equity purchases during this time span. In stark contrast, and as noted in our last *FAR*, U.S. investors made net sales of $4.2 billion for the decade of the 1980s. Entering the 1990s, U.S. investors were significantly under-weighted in Japanese equities. The 40% decline in the Tokyo market in 1990 created an opportunity for U.S. investors to increase their portfolio allocation to Japanese equities. The strategy by U.S. investors to move in after a 40% market decline may be a function of a longer-term approach being taken by U.S. fund managers in buying foreign equities and their need to diversify. Nearly three-quarters of U.S. money managers polled (*Broadgate Consultants, Inc.*) said that long-term capital gain was their primary reason for investing in foreign equities. About 60% said the same about diversification. This foray into Japanese equities is not just a U.S. phenomena. A *Smith New Court-Gallup Poll* of institutional money managers showed that 63% (the highest figure recorded since the survey began last year) of those interviewed in the U.K. were preparing to increase their holdings of Japanese equities.

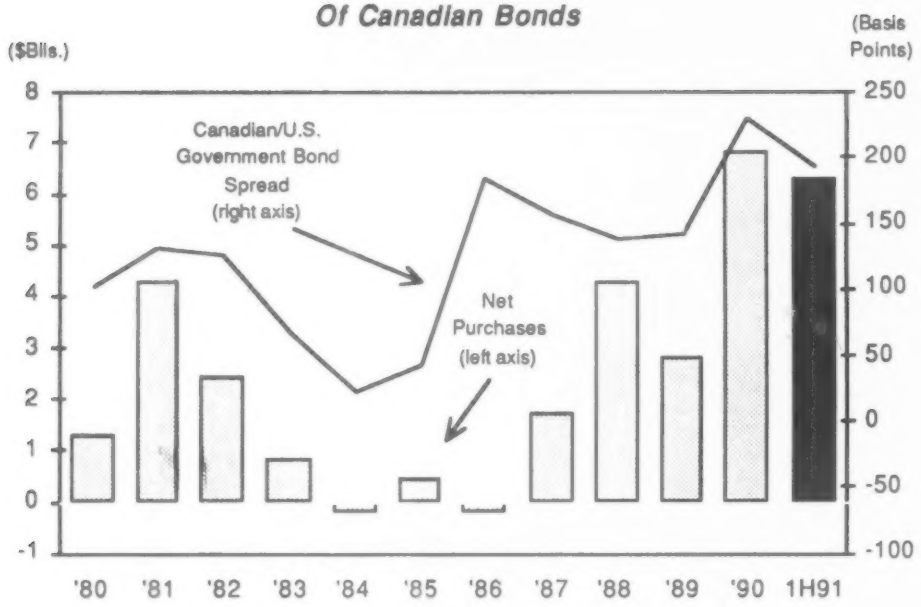
GROSS TRANSACTIONS IN AND NET PURCHASES OF
FOREIGN BONDS BY U.S. INVESTORS
($Mils.)

	FIRST QUARTER 1991		SECOND QUARTER 1991		% CHANGE
	GROSS ACTIVITY	NET PURCHASES	GROSS ACTIVITY	NET PURCHASES	IN GA 2Q91-1Q91
EUROPE	$135,838	$714	$62,447	($427)	(54.0%)
EUROPEAN COMMUNITY	$127,847	$587	$60,096	$148	(53.0%)
BELGIUM/LUXEMBOURG	3,927	173	1,743	(211)	(55.6%)
DENMARK	3,372	(174)	402	10	(88.1%)
FRANCE	11,272	1,538	1,935	247	(82.8%)
GERMANY	12,230	(1,918)	2,307	(369)	(81.1%)
GREECE	48	(26)	8	(6)	(83.3%)
IRELAND	398	(16)	322	178	(19.1%)
ITALY	5,295	283	1,106	(72)	(79.1%)
NETHERLANDS	3,873	453	1,972	1,176	(49.1%)
PORTUGAL	47	(41)	10	2	(78.7%)
SPAIN	1,991	197	1,029	(59)	(48.3%)
UNITED KINGDOM	85,394	118	48,075	(655)	(43.7%)
SWITZERLAND	2,773	(43)	1,187	(93)	(57.2%)
CANADA	20,001	1,753	26,516	4,536	32.6%
LATIN AMERICA & CARIBBEAN	11,995	(539)	7,974	454	(33.5%)
MEXICO	235	15	978	770	316.2%
ASIA	36,222	(170)	23,959	(533)	(33.9%)
JAPAN	28,028	650	17,153	(159)	(38.8%)
OTHER	8,055	1,351	3,430	(300)	(57.4%)
TOTAL ALL COUNTRIES*	$212,111	$3,109	$126,593	$4,195	(40.3%)

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

U.S. investors made net purchases of foreign bonds of $4.2 billion during 2Q91. As in the first quarter, acquisitions was focused on Canadian fixed-income products. Acquisitions for the year now total $6.3 billion and are rapidly approaching the record high of over $7 billion in 1990. With yields on U.S. bonds falling, U.S. investors moved into the higher yielding Canadian market. Indeed, by the end of June, Canadian governments not only showed yields above those offered in most other major bond markets, but also showed a 1H91 total return (U.S. dollar) of almost 8%.

U.S. Net Purchases
Of Canadian Bonds



In general, this is turning out to be a banner year for issuing debt by Canadian issuers, as the federal and provincial governments, as well as private issuers, have flooded the market with new offerings. While U.S. investors have been the most voracious purchasers, data from *Statistics Canada* shows the interest to be worldwide. This is of no small consequence to Canadian issuers in general, and the federal and provincial government in particular, which depend on foreign investors for their capital needs.

One of the more interesting features of U.S. interest in foreign bonds is the 40% decline in activity in 2Q91's trading compared to that of 1Q91. Activity levels more than halved in Europe, and plunged as much as 80% in countries such as France and Germany. In all fairness, though, it should be noted that the activity levels seen in 1Q91 (and 4Q90 for that matter) averaged $211.1 billion, well above historical levels. Activity in 2Q91, at $126.6 billion, was more in-line with levels prior to 4Q90. For example, transactions per quarter averaged $111.1 billion and $118.6 billion in 1988 and 1989, respectively. Activity levels may have jumped in these two quarters as U.S. investors, searching for higher yields, dealt with a surprise rally in the dollar and the uncertainties posed by the Gulf War.

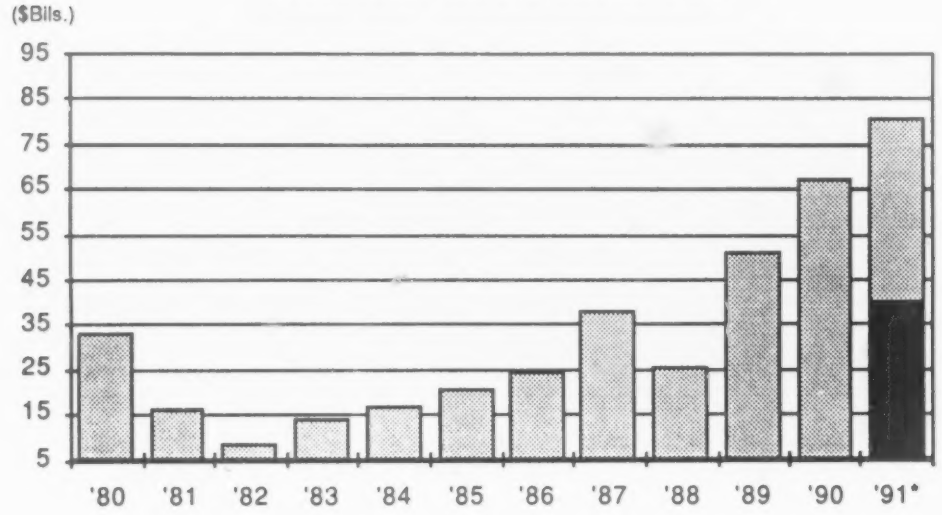
1H91 Total Rates Of Return For Selected Government Bond Markets

	U.S. $	*Local Currency*
A$	8.41	9.15
C$	7.98	6.33
U.S.$	3.48	3.48
¥	1.23	2.76
£	(9.74)	7.46
Ffr	(10.47)	8.17
DM	(12.50)	6.16
Dfl	(12.56)	5.85

Source: Salomon Brothers Inc

Finally, despite the troubles in the Italian economy, several market developments may increase U.S. participation in this market. First, it has been suggested that the Italian Finance Ministry consider abolition of the withholding tax on foreign investors. Secondly, futures on Italian bonds have now been introduced on the LIFFE and MATIF exchanges affording U.S. investors a way to hedge risk.

U.S. Acquisitions Of Foreign Direct And Portfolio Investments



*Annualized; 1H91 acquisitions noted by dark shading

On a broader scale, U.S. acquisitions of foreign assets continues at a relatively high level. In fact, at an annualized rate, U.S. acquisitions of foreign assets will total near $80 billion, well above the previous high in 1990 of $67.4 billion. Moreover, U.S. acquisitions have increased every year (except the post-crash year of 1988) since 1982. The pace of acquisitions places the U.S. as one of the world's major international investors once again. Just a few years ago, the halls of Congress were filled with rhetoric about foreign takeover of U.S. assets. Indeed, given the problems of the 1980's largest capital exporter, Japan, the U.S. may find itself the leading capital exporter. Now that's food for thought!

So what does this all mean? After all, foreign investors played a major role in financing U.S. capital needs in the 1980s by generously investing their domestic savings in our market. But now, the massive flows we saw in the mid-to-late 1980s seem a distant memory and unlikely to return soon. At the same time, U.S. investors are sending record amounts of U.S. savings overseas. And, to complicate matters, U.S. capital needs are further strained by a banking crisis. When we combine this with a U.S. saving rate which is near historic lows, it is reasonable to be concerned about the prospects for future economic growth.

The U.S. precariously treads on the road to economic recovery. The question of who will finance the capital needed for expansion, is a practical one, and not just an academic one. Either we stimulate greater domestic savings or we encourage foreigners to invest in the U.S. It would seem that we have more choices with the first alternative.

David G. Strongin
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Finance